ISRG Journal of Education, Humanities and Literature (ISRGJEHL)

ISRG PUBLISHERS
Abbreviated Key Title: ISRG J Edu Humanit Lit
ISSN: 2584-2544 (Online)
Journal homepage: https://isrgpublishers.com/isrgjehl/
Volume – I Issue-I (January- February) 2024
Frequency: Bimonthly

The effect of fiscal policy on economic growth

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| **Received:** 07.01.2024 | **Accepted:** 13.01.2024 | **Published:** 18.01.2024

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Abstract

The correlation between fiscal policy and economic growth has garnered significant interest recently. The economic expansion witnessed by various countries in recent decades has led to the emergence of a substantial body of theoretical and empirical literature aimed at elucidating these phenomena. There is a valid argument that can be made regarding the reciprocal relationship between economic growth and fiscal policy. This study examines the research undertaken on fiscal policies and their impact on economic growth. It is important to note that fiscal policy encompasses three main tools: government expenditure, taxation, and debt. Moreover, based on prior research, the correlation between fiscal policy and economic growth is ambiguous and inconsistent, with instances of both positive and negative associations. This study will examine the concept of fiscal policies, economic growth, and the correlation between these two factors based on prior research.

Keywords: *Fiscal policy, Economic growth, Government Expenditure, Taxation.*

Introduction

The literature extensively documents the impact of fiscal policy on the economy, as evidenced by studies conducted by Hlongwane et al. (2018), Al-kasasbeh (2022), Ahmad et al. (2020), and Pamba (2021). The existing research in this field emphasizes that fiscal policy has the capacity to impact economic growth through both macroeconomic and microeconomic mechanisms (International Monetary Fund 2011). Kim et al. (2021) contended that fiscal sustainability is the fundamental basis for maintaining macroeconomic stability.

The factors that influence economic growth continue to be a significant and compelling subject of study in the discipline of economics, while many questions regarding them remain unresolved. The essential inquiry at hand is whether fiscal policy exerts an influence on economic growth or not? The growth of the fiscal policy sector is disputed theoretically based on three dimensions: feedback, demand, and supply hypotheses (Ziaei, 2015). When policy makers face challenges in identifying potential economic development and ensuring a stable economy for their countries, the relationship between fiscal policy and economic growth becomes increasingly crucial. The importance of new

research in this field lies in its implications for the economic progress of each country (Kasasbeh, 2021; Jayeola, 2022).

In addition, numerous studies have examined the correlation between government spending, taxation, public debt, and economic growth. Various studies have extensively examined the aforementioned themes, focusing mostly on fiscal policy variables. These references include the works of Herndon and Pollin (2014), Lof and Malinen (2014), Kia and Mousavi (2015), Gale, Krupkin and Rueben (2015), Alawneh (2017), Abueid et al. (2018), Al-kasasbeh (2022), and Kasasbeh (2021).

The examination of economic growth and fiscal policy is a subject of great interest to scholars such as Tcherneva (2011), Audu (2012), Karagöz and Keskin (2016), Nursini (2017), Ugwuanyi & Ugwunta (2017), and Al-kasasbeh et al. (2022). All of these investigations sought to uncover the connection between them. Economic growth performance is commonly attributed to various elements, including energy consumption, international trade, financial development, CO2 emission, population, monetary policy, and others.

In addition, recent studies have focused on examining the effects of fiscal policy factors in advanced economies, as evidenced by the works of Stoilova and Patonov (2013), Atilgan, Kilic, and Ertugrul (2017), and d'Agostino, Dunne, and Pieroni (2018). The aforementioned considerations prompted the researcher to ascertain fiscal policy as a key instrument for economic progress.

Fiscal policy

There is no doubt that economic policies include several measures such as fiscal and monetary policy and policy on credit and exchange rates. Fiscal policy plays an important position in these policies, because the various objectives they are looking for can be reached. The national economy depends on its various tools, which can be adapted to affect all the economic and social aspects of society, the government's approach to the economy was laissez-faire. After the Great Depression, ideas emerged calling for their intervention in economic life to regulate unemployment, inflation and business cycles.

Fiscal policy has become a major instrument of economic policy in guiding the economic course and addressing what is exposed to shocks and crises. Their different definitions of the concept of fiscal policy (Al-kasasbeh, 2023). For example, it is defined as a set of public revenue policies for public expenditure in order to achieve specific objectives. On the other hand, some define it as a set of goals, directions, actions, and activities adopted by the state to influence the national economy and society to maintain its overall stability and development (Tcherneva, 2011).

The fiscal policy situation remained neutral until appeared on the horizon of the economic crisis that swept the world in 1929. It can be said that the significant development of fiscal policy has stemmed from the major contribution to the great economist John Maynard Keynes in his book "The General Theory of Jobs and Interest and Income", when emphasizing the weakness of market mechanisms alone in coping with economic problems, especially the Great Depression crisis, and the consequent need to follow Keynes views of state intervention in economic activity. Since then, fiscal policy has assumed a more critical role and has become a major instrument of economic policy tools to guide the economic entity's course and address what it is exposed to shocks and crises, as well as their impact on the development of the economy, in particular, in the growing countries (Hoover, 2015; Al-kasasbeh et al., 2022).

According to Ugwuanyi and Ugwunta (2017), fiscal policy includes many patterns affecting economic activities such as government spending, public debt, and taxation, as well as influencing employment and aggregate demand growth level. Fiscal policy strengthens policymakers ability to manage the economy by managing their income and spending power to achieve specific goals that lead to economic growth. Fiscal policy also represents government policies related to the state budget, which is represented in tax revenue, government borrowing, government spending, or even deficit financing (Sanni, 2012). Fiscal policy's main objective is to provide countries with economic stability by improving economic conditions and factors in a way that strengthens the state's business and ensures that government decisions are appropriate for economic stability (Ndubuisi, 2017).

Historically, there are numerous points of view on the success of fiscal policies that have been pursued by different economic schools from time to time. The classic approach, which prevailed until The Great Depression (1929), highlights the importance of a balanced budget for the efficiency of fiscal policies. It also pointed out that budget deficits are likely to create economic instability. Classical economists also claimed that budget should generally be identical, apart for some variations. They also argued that the effectiveness of government spending or tax regulations was related to strategies through which such policies were shaped and implemented (Erkam, 2010).

However, the classic approach with its assertion of financing the budget deficit through borrowing and its consequential obscurity has failed to resolve the crisis in the absence of its inability to predict The Great Depression. Confirming that the government should intervene in the economy through revenue, public spending and the budget, Keynesian views opened the debate to the principle of a balanced budget and pointed to the relevance and macro-economic impact of the imbalanced budget (Karagöz and Keskin, 2016). Keynesian view argues that the effectiveness of monetary policy tools is limited due to liquidity trap and other factors and it argues that aggregate demand could be complemented by public spending and public revenue. Thus, in order to reduce inflation, fiscal policy should be applied by following budget surplus policy, while in the time of recession monetary expansion would be provided by budget deficit (Bozkurt & Göğül, 2010).

According to Keynesian argument, the fiscal contraction leads to a temporary contraction through aggregate demand channel. A frequently used and popular Keynesian-Monetarist contention in theory of economics further clarifies the effectiveness of fiscal policy. Monetarist view holds economy to be generally stable and believes interventionist monetary policy to be objectionable and thus, consequentially, fiscal policy to be harmful (Erkam, 2010). Meanwhile Friedman says, if intervention is inevitable, monetary policy should be preferred to fiscal policy because of the delayed impacts of fiscal policy (Dudley-Evans, 2017).

Empirical Literature Review

In this section of the paper, a series of previous research and studies on the subject of fiscal policy and its relation to economic growth in a number of countries will be presented in order to gain a deep understanding of the nature of the relationship between fiscal policy and economic growth, as follows:

Table 0.1: Summary of Previous Empirical Literature Review

	AUTHORS	COUNTRY AND DATA	METHOD	MAJOR FINDINGS
	TAXES AND ECONOMIC GROWTH			
1	Ivanyna, Moumouras, and Rangazas, (2016)	developing countries	dynamic general equilibrium model	(-)
2	Aghion, Akcigit, Cage, and Kerr, (2016)	U.S states	Granger causality	→
3	Riba, (2017)	South Africa 2003 - 2016	ARDL cointegration and Granger causality	(+) ↔
4	Biswas, Chakraborty, and Hai, (2017)	U.S. state	GMM, and OLS model	(-)
5	Di Sanzo, Bella, and Graziano, (2017)	panel of twenty European countries 1970 to 2012	VAR model	(-)
6	Babatunde, Ibukun, and Oyeyemi, (2017)	Africa from 2004 to 2013	Hausman test	(+)
7	Grdinić, Drezgić, and Blažić, (2017)	Central and Eastern Europefrom 1990 to 2010	(GMM) regressions	(-)
8	Juliana, (2018)	Nigeria 1994 to 2016	cointegration test	(+)
	PUBLIC DEBT AND ECONOMIC GROWTH			
9	Stylianou (2014)	Greece during the period1980 to 2010	Granger causality test	~
10	Al-Refai (2015)	OECD nations 1981 to 1995	OLS	(-) (+)
11	Chiu and Lee (2017)	61 countries 1985–2009	panel data framework	(+) (-)
12	Cherif, and Hasanov (2018)	USA	VAR	(-)
13	Ferando and Serafim (2018)	Angola 2004-2015	panel data approach	(-)
14	Gómez-Puig, and Sosvilla (2018)	euro area (EA) the period 1961-2013	Autoregressive Distributed Lag (ARDL) bounds	(-)
15	Esteve, and Tamarit (2018)	Spanish economy 1851–2013	dynamic ordinary least squares (DOLS) method	(-)
16	Ncanywa, and Masoga (2018) Kasasbeh (2021)	South Africa Jordan	autoregressive distributive lag Granger causality	(-) ↔
	Government Expenditure and Economic growth			
17	Alptekin, and Levine, (2012)	review 32 empirical studies	panel Granger causality test	~
18	Keho (2015)	Ten African countries. over the interval 1965 to 2013	Granger causality test	↔ →
19	Osei, Aglobitse, and Bentum–Ennin, (2017)	Thirty-threecountries from 1990 to 2014.	Autoregressive Distributed Lag (ARDL)	(+)
20	Atilgan, Kilic, and Ertugrul, (2017)	Turkey 1975–2013	autoregressive-distributed lag approach (ARDL)	(+)
21	Paul, and Furahisha, (2017)	Tanzania over the period of 1978 to 2014.	Johansen test of cointegration and Granger causality	(+) →
22	d'Agostino, and Dunne, and	109 countries 1998–2014	panel data methods	(-)

	Pieroni, (2018)			
23	Abad, Haron, and. Abueid, (2018)	Jordan for the period 1970-2017	(ARDL)	→
24	Le Van, Nguyen-Van, Barbier-Gauchard, and Le (2019) Alkasasbeha, Haron, Abueid, (2018)	UAE 1975Q1-2012Q4 Jordan 1970-2017	annual data analyses (ARDL)	(+) (+)

→ Means that the causality runs from economic growth to its determinants
← Means that the causality runs from the determinant of the economic growth to economic growth
↔ Means that bi-directional causality exists between economic growth and its determinants
~ means that no causality exists between economic growth and its determinants
(+) Means positive relationships between economic growth and its determinants
(-) Means negative relationships between economic growth and its determinants

The various empirical studies analyzed here reported inconsistent and inconclusive outcomes. For example, there are substantial positive and bidirectional relationships between economic growth and government expenditure, taxes, and public debt, and negative relationships have been documented in some studies. Other studies record various results. This mixture of outcomes and conclusions comes from differences in methodology, specific times of study and variables used.

Conclusion

This paper seeks to determine whether a consensus exists about the impact of fiscal policy on economic growth. In reference to selected articles, were found to report a negative relationship between fiscal policy and economic growth. However, the results also suggested that the relationship may be positive. Similarly, there were studies that supported the neutrality of fiscal policy and economic growth. Therefore, there is no unanimity regarding the connection between fiscal policy and economic growth. The nature of the relationship may be positive, negative, or neutral. Overall, this review demonstrates that the effect of fiscal policy on economic growth is not constant and varies depending on a number of heterogeneous factors, such as the research methodology used, the level of development of the sampled countries, the relative size of the public sector, institutional quality, the composition, and the selected control variables, among others. The study finds, therefore, that the influence of fiscal policy on economic growth is ambiguous.

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